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SUBJECT: HONDURAS ECONOMIC REFORM: DEPOSIT INSURANCE AGENCY  
STRENGTHENED

REF: A) 03 Tegucigalpa 2062

B) 04 Tegucigalpa 232

C) 04 Tegucigalpa 1984

[11.](#) (U) SUMMARY: In September 2004, at IMF insistence, the GOH passed four banking reform laws aimed at strengthening the nation's financial system. While the GOH missed the IMF's target date by nearly three months, the laws passed in late September do meet the terms of the IMF agreement and, more importantly, should go a long way to strengthening the country's fragile financial system. This cable focuses on the deposit insurance agency reform law and is the first in a series of four cables that will analyze each of the recent laws, assess their impacts on the Honduran financial system, and outline challenges of implementation or additional needed reforms that remain.

[12.](#) (U) On September 22, the Honduran Congress passed a law that reforms the Honduran deposit insurance agency, FOSEDE (Fondo de Seguro de Depositos) in three major ways. First, it simplifies FOSEDE's function, removing the responsibility for resolving and recapitalizing stressed banks, so that FOSEDE becomes strictly a deposit insurance fund. Second, it leaves FOSEDE as the only deposit insurance agency operating in the country, removing additional guarantees on deposits that the GOH had provided since 1999. Third, the law changes the way that FOSEDE is capitalized, adding some sources of funding while removing others. These changes should strengthen the financial system by giving FOSEDE a clear mandate - to insure bank deposits - and by providing it with sufficient capital to do that job, while greatly reducing the financial costs and moral hazard implicit in the earlier system. However, concerns remain that FOSEDE is not sufficiently capitalized to handle a failure of one of the country's major banks. END SUMMARY.

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BACKGROUND: THE NEED FOR REFORM  
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[13.](#) (U) In May 2003, the IMF released its "Financial System Stability Assessment" for Honduras, based on the work of a joint IMF/World Bank Financial Sector Assessment Program (FSAP). The report concluded that the Honduran banking system is "highly fragile at a systemic level, impairing sustainable economic growth," and outlined several reforms needed to strengthen the system. (Ref A provides a summary of this report and its recommendations.) The FOSEDE reform law directly addresses two specific recommendations from that report: "improve the framework for crisis management and bank resolution" and "create the appropriate conditions for a smooth transition towards a partial deposit insurance." These recommendations were incorporated as Structural Performance Criteria in the Letter of Intent signed by the GOH and the IMF in February 2004 (ref B). The Letter of Intent set a target date of June 30 for passage of the four reform bills: the Deposit Insurance Law; the Central Bank of Honduras Law; the Banking Commission Law; and a new Financial Institutions Law. While the GOH missed this deadline by nearly three months (ref C), the laws were passed just in time for the IMF Board's six-month review of Honduras' performance under the Poverty Reduction and Growth Facility (PRGF) arrangement.

[14.](#) (U) The new FOSEDE law marks the third time in barely five years that the GOH has overhauled its deposit insurance scheme. However, this is the first time that the reforms have been made pro-actively, as a result of deliberate planning and technical analysis, rather than reactively, as a sudden response to the political pressure generated by a collapsing bank. The first deposit guarantee scheme in Honduras was established 1999 when a major bank, Bancorp, collapsed due to fraud and mismanagement. Regulators in the National Commission for Banks and Insurance (Comision Nacional de Bancos y Seguros, or CNBS) closed the bank, and Congress created a temporary deposit insurance fund to

provide 100 percent compensation to depositors and preserve the financial system's stability. The second overhaul came in 2001, when the GOH created the current deposit insurance agency, FOSEDE, to pay Banhcraser depositors following the collapse of that bank (though depositors in uninsured institutions associated with Banhcraser still lost their savings).

15. (U) Even after FOSEDE was created, however, it still did not bear sole responsibility for deposit insurance. Instead, FOSEDE provided insurance for the first \$9,633 per depositor, per institution, and Congress continued to cover the remaining amount, up to 100 percent of deposits. The 100 percent coverage was envisioned to be a temporary arrangement, to give time for a sustainable restructuring of the system. However, only limited restructuring and consolidation took place. The first reduction in GOH coverage, from 100 percent to 50 percent, was scheduled for September 2002, but one week before the reduction was due to take place, it was postponed for a year by Congressional decree. GOH coverage was finally reduced to 50 percent in September 2003 and on September 30, 2004, was removed entirely, leaving in place only the guarantees provided by FOSEDE.

16. (U) The financial and economic costs of 100 percent coverage of deposits were substantial. Covering all deposits is expensive and exposes the government to insupportable financial liabilities. Nor could public welfare be invoked to justify this added expense, since 98 percent of deposits in the Honduran banking system were below \$10,000 and hence were already covered by FOSEDE. In other words, full coverage was a safety net that benefited only the two percent of depositors who had bank deposits over \$10,000. (Comment: These politically influential individuals were likely responsible for the government's delay in removing 100 percent coverage. End comment.) Of greatest concern, a 100 percent guarantee of deposits creates moral hazard (that is, it establishes incentives for increasingly irresponsible behavior) throughout the banking system, as it undermines both bankers' and depositors' incentives to manage the risks in their portfolios. The 100 percent guarantee provides depositors with an incentive to place their savings in whatever bank pays the highest interest rate, regardless of that bank's stability. To attract these deposits, banks invest in increasingly risky ventures to enable them to offer higher rates of return.

17. (U) FOSEDE also suffered from an overly-broad mandate that did not allow it to focus on its core mission of deposit insurance. Under its 2001 charter, FOSEDE was also responsible for assisting stressed banks through intervention and recapitalization. While there is no inherent conflict in having these two functions reside in the same institution, in practical terms the large costs involved in taking over and recapitalizing stressed banks detracted from FOSEDE's ability to act as a credible insurer of deposits for the rest of the financial system.

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CHANGES UNDER THE NEW LAW  
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18. (U) On October 29, EconOff met with President of FOSEDE Rosa Lidia Montes de Oca to discuss the new law and the changes that it would require. Unlike the President of the Central Bank or the Banking Commission, who each serves four-year terms, Montes was appointed in 2001 for a five-year term, specifically designed not to correspond precisely with the four-year electoral cycle, in the hope that the position would be seen as more of a technical and less of a political appointment.

19. (U) According to Montes, the September reform law addresses all of the problems with FOSEDE described above. By stripping FOSEDE of its function as a rescuer of ill banks, the reform allows it to focus exclusively on its role as a deposit insurance agency. The National Banking and Insurance Commission, CNBS, now has responsibility for resolving and recapitalizing stressed banks (septel).

110. (U) The new law also removes (as of September 30, 2004) the additional deposit insurance that the GOH had provided since 1999 and leaves FOSEDE as the only deposit insurance agency operating in the country. Coverage for deposits in insured institutions is therefore now capped at \$9,633 per depositor, per institution. This odd limit is an artifact of the movement of the exchange rate between the drafting and ratification of the original 2001 FOSEDE law. Depositor protection was denominated in Lempira equivalent and is now adjusted annually such that the dollar value does not vary.

111. (U) The reform law seeks to re-establish FOSEDE's stability and reliability by modifying the way it is capitalized. (Comment: This change is crucial. FOSEDE was born with a negative net worth -- inherited from the

previous deposit scheme -- and went even further into debt when it had to borrow from the Central Bank to rescue two small banks in 2002. End Comment.) The new law provides FOSEDE with a one-time grant of \$25 million, of which \$10 million is provided by the CNBS, and \$15 million is made available from the InterAmerican Development Bank's Financial Sector Program (IDB loan number 1533/SF-HO). In addition, all financial institutions covered by FOSEDE will continue to make assessed contributions - presently 0.25 of deposits annually -- but subject to future revision if necessary. However, the law also states that once the payment of \$25 million is made, the Central Bank's guaranteed line of credit to FOSEDE shall be removed, meaning that FOSEDE will no longer be able to borrow from the Central Bank as it has done in the past when it needed funds.

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NEXT STEPS  
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12. (U) FOSEDE is currently preparing the regulations for the new law, with assistance from consultants paid for by the World Bank and the IDB. Montes does not foresee this implementation effort posing a major burden on FOSEDE, since its function is being reduced, not expanded. However, she said, it will take years to fully finance FOSEDE, even with the \$25 million infusion of cash that the new law provides and a possible increase in assessments on member institutions.

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COMMENT: FEARED JITTERS HAVE NOT MATERIALIZED...  
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13. (U) Comment: The reform of FOSEDE, though technical and circumscribed in scope, is an important example of a Honduran economic policy success - one whose implementation has gone better than some experts had expected. The difficulty in achieving a smooth transition to a limited deposit insurance system was one of the major concerns raised by the 2003 IMF/World Bank FSAP report, which warned that "the elimination of the blanket guarantee... by September 2004 may produce market instability, given current systemic weaknesses." In the event, there are no immediate signs that this has been the case. CNBS officials have expressed confidence that the successful passage of all four financial reform laws before the September 30 elimination of additional deposit insurance contributed to the stability of the transition and boosted confidence across the financial sector.

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...BUT THE REAL TEST LIES AHEAD  
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14. (SBU) Comment (cont'd): However, two concerns remain. The first, as mentioned above, is the fact that FOSEDE is still not fully capitalized. FOSEDE President Montes made it very clear that, now and for at least the next few years, FOSEDE can only handle the failure of a small or medium-sized bank. There remain, in other words, banks in the system that are "too big to fail." Second, in the event of another bank failure, would the Honduran Congress really stand by and allow the wealthiest 2 percent of Honduran account holders (including, of course, most members of Congress) to lose their uninsured deposits? Post considers it more likely that political pressures to intervene would prove too strong to resist, as they did during the 2003 bailout of the agricultural sector that eventually cost the GOH an estimated 1.7 percent of GDP. Despite these concerns, however, Post believes that these financial reforms, and the FOSEDE reform law in particular, constitute a significant step forward toward stability of the Honduran financial system.

Pierce